Euro wrap-up

Overview

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- Gilts were little changed as UK Q3 GDP data fell slightly short of expectations, thus likely leaving the BoE's December monetary policy a very close call.
- Bunds made losses as the ECB's Austrian hawk Holzmann said that the bank's net bond purchases could end as soon as next September but the European Commission forecast euro area inflation to be below 2% in 2023.
- Friday will bring euro area industrial production data for September and final Spanish inflation figures for October.

Daily bond market movements

Bond	Yield	Change
BKO 0 12/23	-0.711	+0.003
OBL 0 10/26	-0.518	+0.025
DBR 0 08/31	-0.227	+0.025
UKT 0⅛ 01/24	0.573	-0.001
UKT 0⅜ 10/26	0.713	+0.003
UKT 0¼ 07/31	0.929	+0.007

*Change from close as at 4.00pm GMT.
Source: Bloomberg

UK

Q3 GDP falls slightly short of BoE expectation leaving December rate call in the balance

UK GDP grew a touch more than expected in September, up 0.6%M/M to hint at a firming of momentum ahead of the fourth quarter. However, that followed a downward revision to growth in August (of 0.2ppt to 0.2%M/M) and a contraction in economic activity in July (-0.2%M/M). As a result, over Q3 as a whole, UK GDP rose 1.3%Q/Q, moderating significantly from growth of 5.5%Q/Q in Q2 and 0.2ppt lower than the Bloomberg consensus forecast. More importantly perhaps, growth in Q3 was also 0.2ppt below the BoE's central projection. That forecast miss, however, seems unlikely to influence the balance of views on the MPC one way or the other. The BoE will probably continue to expect growth of around 1.0%Q/Q in Q4 (we now expect growth of 0.9%Q/Q). And next week's labour market data (and the following set next month) will probably be more important in determining whether or not the Committee votes for a hike on 16 December. Nevertheless, the extent of the slowdown in Q3 will have been a disappointment, not least as it left the quarterly level of UK output still some 2.1% below the pre-pandemic peak in Q419. UK growth in Q3 also therefore fell some way short of the euro area (2.2%Q/Q) and each of the five largest member states, but outpaced the US (0.5%Q/Q). More notably, the shortfall of GDP from the pre-pandemic level in Q419 looks to have been greater in the UK than any other G7 country.

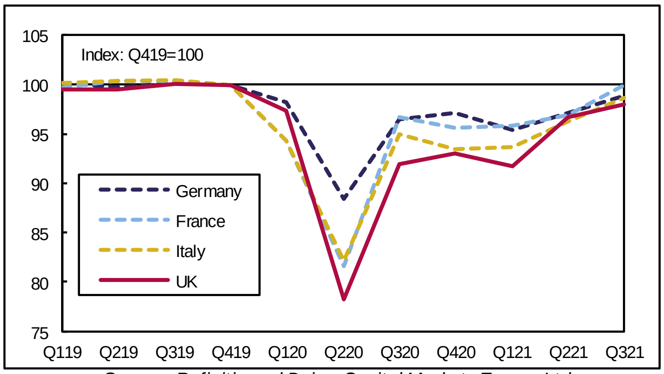
Services grow as restrictions ease, but manufacturing and construction hit by supply constraints

As in the euro area, UK economic growth in Q3 was again led by services as activity rebounded upon the further relaxation of pandemic restrictions. Growth in that sector of 1.6%Q/Q in the third quarter followed a leap of 6.5%Q/Q in Q2 to leave activity just 0.7% below the pre-pandemic level. Within the detail, hospitality was especially vigorous, up 30%Q/Q, with arts, recreation and entertainment up almost 20%Q/Q. In contrast, retail and wholesale trade output dropped 2.5%Q/Q on lower sales of goods, with retail sales down each month of the quarter and car sales also weaker. Beyond services, production rose 0.8%Q/Q thanks to a jump of more than 26%Q/Q in mining and quarrying output on the reopening of North Sea sites previously closed for maintenance. But as supply-chain difficulties took their toll, manufacturing output fell 0.3%Q/Q led by declines in rubber and plastics, with production of autos down 0.3%Q/Q. And supply bottlenecks and labour shortages also weighed on construction activity, which fell 1.5%Q/Q.

Consumption the main driver but business investment subdued and net trade very weak

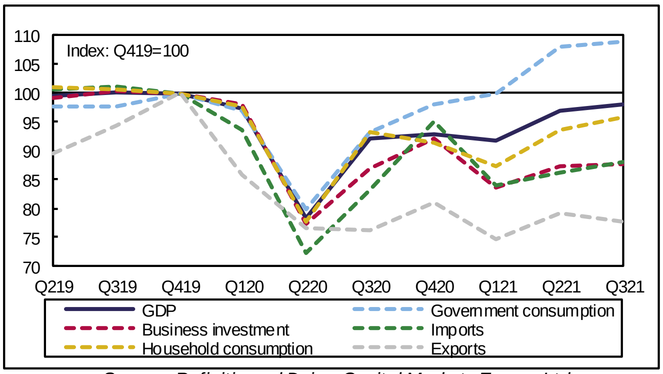
On the expenditure side, household consumption was the main driver of GDP growth in Q3, increasing 2.0%Q/Q, nevertheless still some 4.4% below the pre-pandemic level. A jump in spending at restaurants and hotels (more than 30%Q/Q) and on transport (4.5%Q/Q) was partly offset by lower spending on household goods and services (-9.6%Q/Q), and clothing and footwear (-7.7%Q/Q). Fixed investment rose 0.8%Q/Q. But while government investment rose 4.3%Q/Q,

GDP in the European G7 countries



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: GDP and expenditure components



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

business investment was still subdued, rising just 0.4%Q/Q to be still more than 12% below the pre-pandemic level to suggest that Brexit continues to deter capex. In addition, net trade subtracted 1.1ppt from GDP growth in Q3 as export volumes fell 1.9%Q/Q due to a drop in goods shipments of 5.8%Q/Q led by machinery and transport goods. But import volumes rose 2.5%Q/Q driven higher by fuels, chemicals and certain other goods. Strikingly, while CPB data show that goods export volumes from the advanced economies had recovered to 1.0% above their 2019 average in August, UK goods export volumes were still down some 16% on the same basis at the end of Q3, another illustration of the damage caused by Brexit. Meanwhile, government consumption rose 0.9%Q/Q to be almost 9% above the pre-pandemic on account of increased spending on healthcare, including vaccinations.

Monthly production-side data suggest a smaller shortfall from the pre-pandemic level

Underlying inventories were also judged to be weaker in Q3 on supply-side strains. But stocks contributed positively to quarterly growth seemingly due to arithmetical adjustments. Indeed, the difficulties reconciling the estimates of growth based on expenditure and output were also highlighted by the monthly data for September. Based on these output-based indicators, growth of 0.6%M/M in September left GDP just 0.6% below the pre-pandemic level in February 2020, a much smaller shortfall than implied by the quarterly expenditure figures, which are nevertheless the basis for the BoE's forecasts. Within the detail, growth in September was underpinned by a 0.7%M/M rise in services activity. That was mainly due to a sizeable boost in healthcare activity on the back of a large rise in face-to-face doctor visits and increased used of legal services as home-buyers completed purchases ahead of the conclusion of the stamp duty holiday. But principally reflecting weak wholesale and retail sales, output in consumer-facing services fell 0.6%M/M to be 5½% below the pre-pandemic level. And overall, having merely moved sideways in July and August, services output was 0.6% below the February 2020 level in September. Meanwhile, industrial production fell 0.4%M/M as the distribution of gas dropped by 4.1%M/M and autos output fell 8.2%M/M (admittedly following a cumulative increase of almost 20% over the previous three months). So, IP was still 1.4% below its level in February 2020, with the shortfall in manufacturing an even steeper 2.5%. And while construction output rose for the first month in three in September (1.3%M/M), it was 1.0% below the pre-pandemic level.

UK house prices buoyed by demand and supply imbalances in October

Beyond the GDP data, the overnight release of the RICS residential survey signalled that strong UK house price growth had been maintained in October despite the tapering of the government's stamp duty holiday at the end of September and rising expectations that interest rates would rise over the near term. Indeed, the headline balance (79%) was a touch firmer than in September and only 11ppts below the peak in June. This reflected the ongoing imbalance between supply and demand in the market, with new buyer enquiries having risen to their highest since May but inventories on estate agents' books near record low levels. Against this backdrop, surveyors remained relatively optimistic about their expectations for house prices over the coming three months, with sales expectations only a touch below the long-run average too. Of course, it remains to be seen whether this optimism is maintained once the first rate rise materialises.

The day ahead in the UK

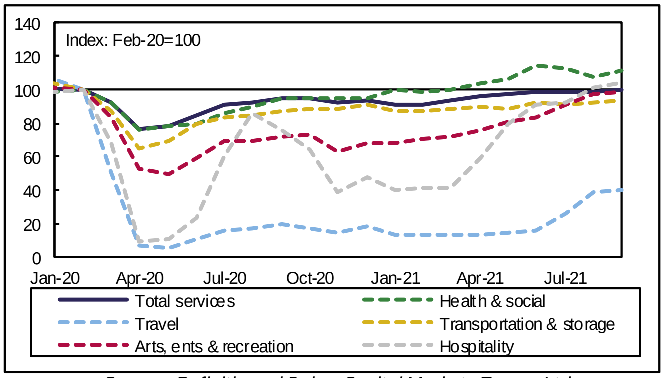
It will be a quiet end to the week for UK economic data, with no releases scheduled tomorrow. But external MPC member Haskel will give a speech on his academic specialism 'Measuring Intangible Assets and their contributions to growth'.

Euro area

German CPI driven by energy, while car prices pushed higher by supply constraints

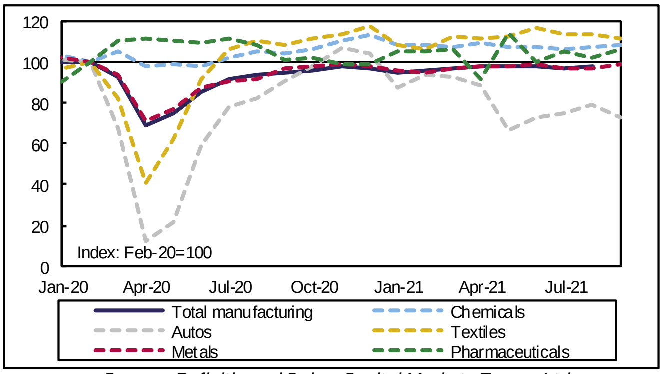
Updated German inflation numbers for October published yesterday suggested that the final euro area CPI release (due 17 November) will align with the flash estimate. There were no significant revisions whatsoever in the German data that showed the harmonised HICP rate jumping 0.5ppt to 4.6%Y/Y, a euro-era high, while the national measure of inflation rose 0.4ppt to 4.5%Y/Y, the highest since September 1993. Within the detail, however, the increase last month was principally driven by the

UK: Services output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

UK: Manufacturing output



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

energy component, which jumped 4.3ppts to 18.6%Y/Y. A surge in the price of heating oil (17.5%M/M) saw it double from a year earlier, while prices of motor fuels rose 5.8%M/M to be up 35%Y/Y. Inflation of natural gas (7.4%Y/Y) and electricity (2.5%Y/Y) ticked higher too. Other goods inflation also shifted higher, with durable consumer goods prices (3.7%Y/Y) driven up by rising vehicle costs. Within this category, the rise in prices of used cars – by a further 2½%M/M in October to leave the annual increase at a series high of 8.6%Y/Y and above that of new cars (6.8%Y/Y) – bore the clear hallmark of supply bottlenecks. In contrast, services inflation edged slightly lower (2.4%Y/Y) from the more than six-year high recorded in September. And so, the national core CPI rate also moved sideways at 2.9%Y/Y. Indeed, the level of core prices rose just 0.1%M/M, representing a third successive month without new pressure following the jump in July. And while the annual rate of core inflation will remain elevated in November and December, it will fall back sharply below 2.0%Y/Y at the start of next year as base effects from the VAT tax change fall out.

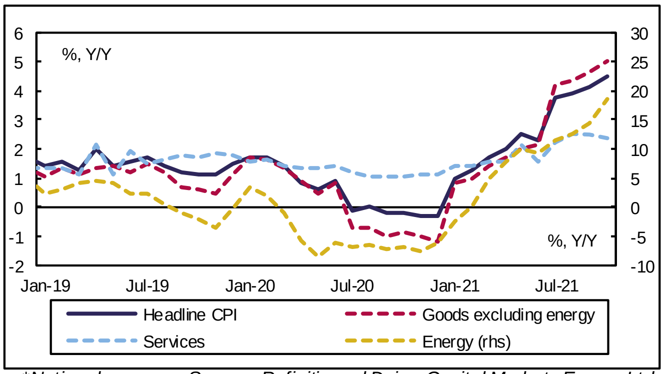
Italian IP holding up well despite a hit to autos production

Italian manufacturers were hardest hit among those of the large member states at the onset of the pandemic as lockdowns took their toll. But the subsequent recovery also outpaced those seen in Germany and France, with Italian output returning (albeit briefly) to its pre-pandemic level within six months. And contrasting with some disappointing outturns in the largest two member states in September, yesterday's Italian production figures once again outperformed. Admittedly, industrial output rose just 0.1%M/M following a decline of 0.3%M/M in August. But this still left it 1½% above the pre-pandemic level and up 1.0%Q/Q in Q3. Production in September was largely supported by a near-19%M/M increase in the pharmaceutical sub-sector. In contrast, production of textiles and clothing and metal products was down by more than 4%M/M. And reflecting the global semi-conductor shortage, output of transport equipment fell for the third consecutive month and by a steeper 7%M/M. This took the cumulative declines in such production to 12% from April's peak and 12½% from the pre-pandemic level. Such shortfalls compare favourably with the auto industries in France and Spain, where output in September was almost a third lower than before the pandemic, and in Germany where output was down more than 40% on the same basis.

The day ahead in the euro area

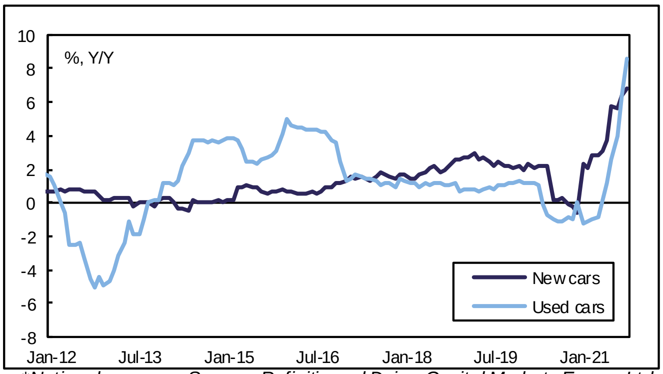
The week concludes tomorrow with the release of the September industrial production report for the euro area. Despite weakness in Germany and France, growth in Ireland and the Netherlands and certain smaller member states should limit the decline in aggregate euro area industrial output to around 0.4%M/M. And that would leave it little changed over the third quarter as a whole. The detail of the report will reveal to what extent supply bottlenecks continue to take their toll on the various subsectors with autos seemingly bearing the brunt. Meanwhile, final Spanish CPI numbers for October are expected to confirm that the national and EU-harmonised measures of inflation rose a whopping 1.5ppts to euro-era highs of 5.5%Y/Y, thanks almost entirely to higher energy prices. Indeed, on the national measure, core CPI is expected to rise just 0.2ppt to 1.2%Y/Y, which will merely be a 16-month high. In other news, ECB Chief Economist Lane will speak at the European Commission's event on the future of the EU's fiscal governance frameworks.

Germany: CPI inflation and key components*



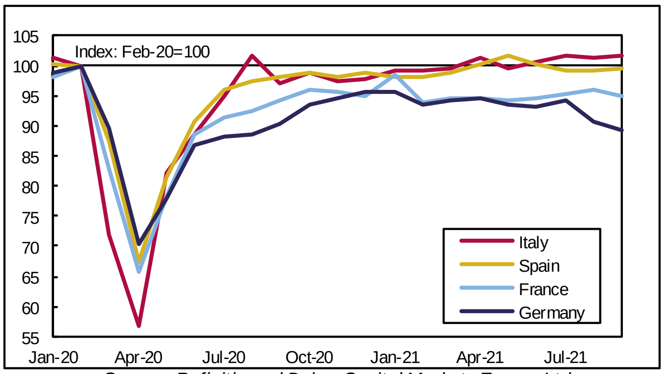
*National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Germany: New and used car price inflation*



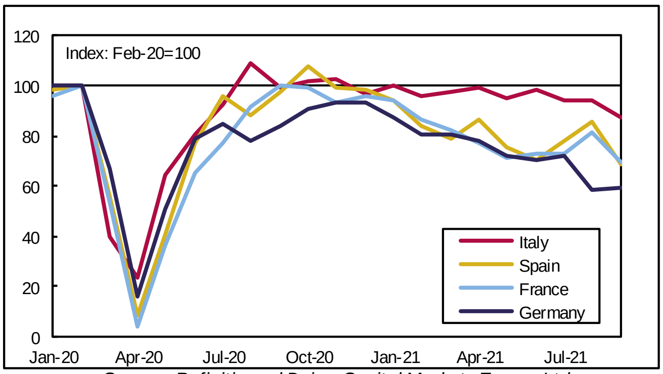
*National measure. Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Industrial production by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

Euro area: Autos production by member state



Source: Refinitiv and Daiwa Capital Markets Europe Ltd.

European calendar

Today's results

Economic data

Country		Release	Period	Actual	Market consensus/ <u>*Daiwa forecast*</u>	Previous	Revised
UK		RICS house price balance %	Oct	**70**	65	68	**69**
		Preliminary GDP Q/Q% (Y/Y%)	Q3	**1.3 (6.6)**	<u>*1.8 (7.2)*</u>	5.5 (23.6)	**-**
		Monthly GDP M/M%	Sep	**0.6**	0.4	0.4	**0.2**
		Services output M/M% (3M/3M%)	Sep	**0.7 (1.6)**	0.5 (1.9)	0.3 (3.7)	**0.1 (3.5)**
		Industrial production M/M% (Y/Y%)	Sep	**-0.4 (2.9)**	0.2 (3.1)	0.8 (3.7)	**1.0 (4.0)**
		Manufacturing production M/M% (Y/Y%)	Sep	**-0.1 (2.8)**	0.2 (3.1)	0.5 (4.1)	**0.3 (-)**
		Construction output M/M% (Y/Y%)	Sep	**1.3 (7.2)**	0.2 (6.9)	-0.2 (10.1)	**-0.7 (9.3)**
		Goods trade balance £bn	Sep	**-14.7**	-14.4	-14.9	**-13.7**

Auctions

Country		Auction
Italy		sold €3.75bn of 0.45% 2029 bonds at an average yield of 0.6%
		sold €2bn of 0% 2024 bonds at an average yield of -0.16%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Yesterday's results

Economic data

Country		Release	Period	Actual	Market consensus/ <u>*Daiwa forecast*</u>	Previous	Revised
Germany		Final CPI (EU harmonised CPI) Y/Y%	Oct	**4.5 (4.6)**	4.5 (4.6)	4.1 (4.1)	**-**
Italy		Industrial production M/M% (Y/Y%)	Sep	**-0.1 (4.0)**	0.1 (4.4)	-0.2 (0.0)	**-0.3 (-0.1)**

Auctions

Country		Auction
Germany		sold €2.46bn of 0% 2031 bonds at an average yield of -0.29%
UK		sold £900mn of 0.125% 2031 index-linked bonds at an average yield of -3.242%

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

Tomorrow's releases

Economic data

Country		GMT	Release	Period	Market consensus/ <u>*Daiwa forecast*</u>	Previous
Euro area		10.00	Industrial production M/M% (Y/Y%)	Sep	-0.4 (4.7)	-1.6 (5.1)
Spain		08.00	Final CPI (EU harmonised CPI) Y/Y%	Oct	5.5 (5.5)	4.0 (4.0)

Auctions and events

Country		GMT	Event
Euro area		13.50	ECB Chief Economist Lane speaks at European Commission event on the future of the EU's fiscal governance frameworks
UK		14.00	BoE's Haskel to speak on 'Measuring Intangible Assets and their contributions to growth'

Source: Bloomberg and Daiwa Capital Markets Europe Ltd.

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